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PRIVATE CREDIT RESTRUCTURING TRENDS: WEARING MULTIPLE HATS AND MANAGING EQUITABLE SUBORDINATION RISK

This article addresses the "equitable subordination" risks that lenders face when they "wear multiple hats," and offers practical insights to mitigate those risks.

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In the current era of complex financing arrangements, it is not uncommon for private credit lenders to find themselves in situations in which they and their borrowers are connected in ways beyond the traditional creditor-debtor relationship. A lender may, among other things, (1) own equity of its borrower, (2) have the right to vote by proxy on behalf of its borrower's equity holders, (3) have the right to appoint to its borrower's board of directors either a "lender-designated" or independent director, and/or (4) control its borrower's board. While these positions and rights generally benefit private credit lenders, they also leave them open to potential risks as they exercise varying levels of control over their borrowers. One such risk is that of equitable subordination, which is a drastic remedy that arises in the context of a borrower's bankruptcy case. In this note, we address the scope of the equitable subordination risk private credit lenders face when they "wear multiple hats" and then provide a handful of suggestions for mitigating those risks.

SCOPE OF THE RISK – EQUITABLE SUBORDINATION

When a borrower files for bankruptcy, the Bankruptcy Code allows for the restructuring of the debtor's debts. Among other things, section 510 of the Bankruptcy Code allows for the equitable subordination of all or part of a creditor's claim to all or part of another creditor's claim, altering the relative priority of claims[1] due to a creditor's misconduct that injures other creditors.[2] While the Bankruptcy Code does not identify

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[1] Equitable subordination is not the same thing as disallowance. However, equitable subordination may leave a claim wholly unsatisfied if that claim is subordinated below the fulcrum security.

[2] Equitable subordination is remedial and is intended to offset harm caused to other creditors. *In re Mid-Am. Waste Sys., Inc.*, 284 B.R. 53, 72 (Bankr. D. Del. 2002). In other words, if the claim exceeds the extent of the harm, the claim should be subordinated only to the extent of the harm. "Harm" is misconduct that (1) creates an unfair advantage for the